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## SUGGESTIONS FOR REVISION OF THE FEDERAL TAX- ATION OF INCOME AND PROFITS

For a year or more the federal excess profits tax has been under fire. No other part of our war finance program has been so strenuously assailed. It seems to be generally assumed that, in the peace-time revision which is due, the excess profits tax will be the first to go.

On the other hand it is evident that for some years the needs of the federal treasury will be heavy. Even assuming that the proper degree of economy is exercised, the ordinary expenditures of the government may be expected to proceed on a scale at least double the pre-war figure. In addition, there is the public debt charge for interest and amortization, which should add more than a billion to the annual expenditure. The revenue obtained from the excess profits tax will therefore be needed, and proposals for abandoning it are usually accompanied by suggested substitutes, such as increases in the personal income tax, the tax on gross sales or turnover, etc. Starting with the assumption that the excess profits tax is to go, root and branch, the task is to find the least objectionable substitute.

I am of the opinion that this method of attack is a bit hasty and superficial. By focussing attention upon the weaknesses of the excess profits tax, we are in danger, on the one hand, of neglecting other parts of the tax system which are defective and, on the other hand, of overlooking features of the excess profits tax which may possibly be worth retaining. Furthermore we run the risk of being stampeded into ill-considered substitutes. The problem of reorganizing the federal tax system involves, in my opinion, a good deal more than getting rid of the excess profits tax and finding the least objectionable substitute. In particular I believe the time has come to harmonize our taxation of personal incomes and corporate profits upon the basis of the personal obligation of each citizen to pay taxes according to his ability. If this essay has any excuse for appearing now, after so many able discussions of our tax problem, it is because it seeks to make some contribution to this end.

The foundation of the federal tax system is and will almost certainly continue to be the individual income tax. The taxation of corporate profits should be for the purpose of rounding out a consistent tax system based upon the individual income tax. All

questions of justice in taxation must finally come down to the individual taxpayers. Corporations as such have no tax-paying ability. The taxation of corporations should be with a view to reaching the tax-paying ability of the investors and others interested in them. In this respect the present tax system, handed down to us as a heritage of the war, is far from perfect. How may it be remodelled with this end in view? The search for an answer will lead us to the consideration of some fundamental, albeit elementary, principles.

An income tax which contained neither personal exemption nor progressive rates could treat individuals and corporations exactly alike. Corporations would be taxed on all their net income, excluding interest paid on bonds and notes. Dividends would not be included in taxable personal income, though interest on bonds and notes would be included. The size of business or the character of its organization (whether individual, partnership, or corporation) would make no difference. There would be no question of undistributed earnings. All earnings would be treated exactly alike, regardless of their later disposition. This simple scheme was in people's minds when the problem of taxing corporations first arose. Under the general property taxes of the states it was assumed that taxing the corporation on all its property was the equivalent of taxing all the stockholders on their shares, and much easier of administration. Barring interstate complications and the question of bonds and notes, this was in the main true. The same idea was in mind when the income tax on corporations was first introduced. Corporate income was taxed in lieu of taxing individual income in the shape of dividends.

But here the scheme breaks down on account of (1) the personal exemptions and (2) the progressive rates of the personal income tax.

1. As regards the personal exemption the matter is simple enough. The corporation is taxed upon all its net income (less \$2,000) regardless of the personal exemptions to which its stockholders may be entitled. Suppose *A* owns \$50,000 of stock in a corporation of \$1,000,000 capital. The corporation's net income is \$80,000, of which *A*'s share is \$4,000. The corporation (assuming no excess profits tax is due) is taxed 10 per cent on its net income, (less \$2,000) or \$7,800, which reduces *A*'s share by \$390. *A*'s dividend is reduced to \$3,610. *B* derives an income of \$4,000 from a business or profession. He enjoys the personal ex-

emption of \$2,000, and his income tax is \$80. Assuming *A* had no other income and was also entitled to the \$2,000 personal exemption, he should have paid no higher tax than *B*. Even if the rate of the corporate income tax were the same as the lowest normal rate of the individual income tax (4 per cent), *A*'s tax liability would have been \$156, double that of *B*, through denial of his personal exemption. This discrimination against income from corporate investment is important, of course, only to those of small incomes. The wealthy and well-to-do will generally have other incomes from which to deduct the personal exemption and, at any rate, the personal exemption is not so serious a matter. But to a large number of small stockholders and persons living on the income of modest investments this is a real and serious injustice. There is no practicable way of correcting it where corporate incomes are taxed in lieu of taxing individuals upon their dividends. It has been ignored in our law.

The remedy is to cease taxing corporations upon their income and to include dividends in the taxable income of individuals. Each individual then receives the personal exemption to which he is entitled.

2. Progression makes it impossible to treat individuals and corporations alike. A progressive income tax on corporations would be meaningless. The whole idea of progression is to reach the tax-paying ability of the individual, taxing the recipients of the larger incomes at successively higher rates. But there is no relation between the size of a corporation's income and the incomes of its several stockholders. A large corporation may be owned by many small stockholders, while a relatively small corporation may be the property of a single wealthy individual. Progression must relate to individual incomes.

This is accomplished roughly in our law by taxing corporations 10 per cent upon their net income (less excess profits taxes and other credits), exempting dividends from the normal rate of the personal income tax, and subjecting dividends to the surtaxes. This is clumsy and only partially effective. The simplest solution is to cease entirely the taxation of corporate income and to include all dividends in personal income.

The fact is that our present tax laws deny to many of the most needy taxpayers the personal exemptions to which the spirit of the law entitles them. They also fall far short of carrying out the principle of progressive taxation. These shortcomings have been

accepted for the sake of a partial application of the principle of stoppage at source with respect to corporate income. Stoppage at source is no longer the fetish that it was a generation ago. Experience has taught us that it has incidental results which are anything but pleasing. The "tax-free covenant" has made trouble in connection with interest on bonds. The best opinion today would reduce stoppage at source to the minimum. Thus the carefully drawn income tax of New York specifically forbids any person to contract to pay the income tax of another. Stoppage at source, even with its recognized administrative advantages, is not a sufficient excuse for the inequalities of our existing tax laws. Most of the advantages of stoppage at source may be retained by requiring "information at the source."

My first suggestion then is to give up the income tax on corporations and to include dividends in individual incomes subject to both normal and surtaxes. This does away completely with the present injustice, as to both the personal exemption and the progressive rates.

This proposition has many other advantages, of which space permits only the mention. It makes the income tax a strictly personal tax. It does away with the false idea of tax-free investments. The taxpayer knows he is taxed. This is good for the taxpayer. It is also good for the state of public opinion, since it removes the public irritation caused by the spectacle of large classes of income exempt (supposedly) from taxation. It brings home to the individual his direct interest in economy of government expenditure and his responsibility for the conduct of government finances. The same arguments apply, of course, to the taxation of interest on bonds. The mistakes already made as to the tax-free covenant should be avoided in future.

Again this change would make corporate stocks a more attractive investment for persons of modest incomes and for estates and trusts held in the interest of such persons. Relief from the income tax would ultimately enable corporations to pay higher dividends, which in the hands of the stockholder would enjoy the benefit of the personal exemption.

For many reasons then, it is desirable that the income tax be made a strictly personal tax, not applying to corporations. But now comes a difficulty on account of the undistributed income of corporations. Under our individual income tax the income of individuals and partnerships is taxable, regardless of whether part

or all of such income is left in the business from which it came. If, as proposed, we should cease taking corporate incomes, the undistributed part of corporation earnings would go untaxed. (I am disregarding for the present the excess profits tax.) The proposed plan then would work equality only when all corporate earnings were distributed in dividends. Undistributed corporate earnings would be favored. For example, suppose *A* and *B* are in the same kind of business, *A* as an individual, *B* incorporated. Each business yields \$10,000 net earnings, of which it is found wise to put \$6,000 back into surplus. *A* pays income tax on the whole \$10,000; his tax (allowing \$2,000 personal exemption) being \$590. *B* pays personal income tax on only the \$4,000 received in dividends; his tax (allowing \$2,000 personal exemption) is \$80. If the corporation pays no income tax, this is his total tax liability, as compared with \$590 for *A*. The difference is due, of course, to the fact that the incorporated business pays no tax on its undistributed earnings. The difference is intensified by the incidental result of putting *B* in a lower bracket for the personal income tax. He pays the 4 per cent normal rate and no surtax. *A* pays 8 per cent normal tax on part of his income and he also pays surtaxes. Again, take the case of *C*, a shareholder in a large corporation. His share of its earnings is \$10,000, of which he receives \$4,000 in dividends, subject to income tax. But the \$6,000 held back for him by the corporation would not be taxed. His income tax is \$80, as compared with *A*'s \$590.

Clearly there would be here an unjust discrimination in favor of corporate investment, as against the individual business or partnership. It can be corrected by some form of tax upon the undistributed earnings of corporations.

Should undistributed earnings be taxed? There is a good argument for not regarding savings as taxable income. According to this theory, all undistributed earnings, being savings, would be untaxed. But this exemption, if granted at all, should be granted to individuals as well as to corporations. Actually this is not the theory of the United States income tax. All individual and partnership earnings are taxed, even though partly put back in the business or otherwise saved. It is not fair to allow the incorporated business to hold undistributed earnings free of tax. Hence some tax on undistributed corporation earnings is needed. This is recognized in a rough sort of way by the present excess profits tax. It is doubtless this idea that has been at the bottom of the

popular irritation at the decision in the stock dividend case, a decision which was undoubtedly correct from every possible viewpoint of theory or practical equity, but which has led people to feel that there ought to be some means of taxing the undistributed earnings of corporations. This popular notion is in harmony with the fundamental theory of our income tax, which it is not proposed to change. A tax on the undistributed earnings of corporations is reasonable. It would remove the chief obstacle in the way of making the income tax a strictly personal tax.

But what of the excess profits tax? Can it be relied upon as a means of taxing the undistributed income of corporations? In a measure it does perform this function at present. But it does it only in the roughest sort of way, in some cases taking an excessive toll from the incorporated business, in other cases falling far short of an adequate tax on undistributed income. In fact the whole spirit and purpose of the excess profits tax is out of harmony with the plan here proposed. Much of the opposition to the excess profits tax is due, I am convinced, to the purposes for which it is conceived to exist, among which may be mentioned the following:

1. The excess profits tax is looked upon as a device for penalizing excessive or improper profits. There is no excuse for such a purpose. If there are profits which should be prevented by law, the law should go about the business directly, not by means of a tax which falls upon the just and the unjust.

2. A tax upon abnormal profits due to special war conditions was justified during the war. Money inflation, government demands, competitive demands of other nations; these and other circumstances gave extraordinary profits to fortunate manufacturers and dealers. It was right for the government to seek a large share of such abnormal war profits. This justification of the excess profits tax ceases with the termination of war conditions.

3. There is a notion on the part of some that there should be a tax upon abnormal profits in general; that is, profits above the supposed normal level. This, I believe, is a mistake. As the term is popularly understood there is no such thing as a normal rate of profits. Profits vary greatly between different kinds of enterprise. All business is speculative, some more, some less. The normal rate of profits, so far as it really exists, is an average rate. In certain years the profits must be higher than such average, in order to offset the years when profits are small or zero. Even

this average is different in different lines of industry. If profits above the "normal" are to be in large part denied, capital cannot take the chances of small profits or losses. Large profits indicate large tax-paying ability and should be treated accordingly. Beyond this, competitive business conditions may be relied upon to take care of the abnormal profits.

4. The excess profits tax is looked upon as a special burden upon corporations as compared with partnerships and individuals, and so far as it is such it is quite rightly condemned.

It is time, I think, to discard all such notions of the purposes to be secured by taxation of corporate profits and to take a fresh start upon the basis of the personal obligation of each citizen to pay taxes according to his ability. What we want is a fair and practicable tax on undistributed corporate income. The excess profits tax is not adapted to the purposes though it has some features worthy of retention. We must seek something better in the way of a tax on undistributed earnings.<sup>1</sup>

In constructing the tax on undistributed earnings, I believe the following principles should govern:

1. The purpose of the tax on corporate undistributed income should be (a) to produce justice as between individuals and partnerships and investors in corporations, and (b) to secure to the government a fair revenue from such undistributed earnings.

2. The purpose should *not* be to force distribution of corporation earnings, or to penalize the putting of earnings back into the business. The purpose to do this, as contained in many current schemes, is bad policy. Tax laws should interfere no more than necessary with the exercise of the best business judgment. But the tax should seek to prevent deferring dividends for the sake of avoiding taxation.

3. Individuals and partnerships pay income tax on all undistributed income. The purpose should be to secure so far as possible equal treatment of corporation undistributed income. Exact equality is of course out of the question. There must be general rules affecting all corporations, regardless of the personal situation of their individual stockholders. The method must be some-

<sup>1</sup> I make no attempt to discuss the many defects of the excess profits tax. That task has been ably performed by others. See in particular Professor Plehn's article in the *AMERICAN ECONOMIC REVIEW* of June, 1920, pp. 283-298 and the series of articles by Professor T. S. Adams in the *New York Evening Post*, July 19-August 18, 1920.



what arbitrary, seeking a fair compromise between small and large stockholders, and making every possible allowance for the small business in the form of the close or family corporation.

4. All undistributed income should pay at least the normal or lowest rate of the individual income tax. No individual (or partnership) can escape at least that much tax. It is true that the individual has the personal exemption. But this can hardly apply to the undistributed income of his business. If he has no other income, he will ordinarily have to take out of his business at least \$1,000 or \$2,000 to live on. This will use up his personal exemption, and all his undistributed income will be taxed. If he has other income to live on, the personal exemption will come out of that, and his business income will be taxed even though all remain in the business. Corporations should therefore be taxed on all undistributed income at least at the normal or lowest rate of the personal income tax.

5. Only a small part of corporate undistributed income should be taxed at this lowest rate. The majority of stockholders have incomes large enough to subject them to higher rates or surtaxes. If conducting business as individuals or partnerships, their undistributed income would be subject to these higher rates. In taxing corporations we must consider the average condition of the stockholders. Hence higher rates than the lowest should generally apply. Otherwise corporation investors would be favored above individuals and partnerships. I shall return later to the discussion of that part of undistributed income taxed at the lowest rate.

6. Determination of the rate of the tax on undistributed income is bound to be somewhat arbitrary, and various plans may be advocated. Some would tax all such earnings at a certain flat rate. This is distinctly arbitrary, though it has the great advantage of simplicity. The plan which I propose sacrifices something on the side of simplicity, but gains much on the side of equity. Opinions will doubtless differ as to the balance of gain or loss, but the plan is one which I believe at least deserves careful consideration. I would propose that all corporate undistributed income (except the small part taxed at the lowest rate) be taxed at progressive rates, by a double scheme of progression.

a. Rates should be progressive according to the ratio of undistributed income to invested capital. As stated, the purpose is to tax fairly undistributed earnings, without forcing distribution but at the same time penalizing the withholding of dividends to escape

taxes. In general, the amount of earnings that ought wisely to be put back in the business is related to the size of the business. A business with \$100,000 capital would not need to put back so much as one with \$100,000,000 invested. Roughly, the amount that should be put back will be in proportion to the capital already invested. In general, the higher the ratio undistributed, the more warranted is the suspicion that the purpose is to escape taxation. Earnings amounting to a reasonable ratio of invested capital should be allowed to remain undistributed upon payment of a moderate tax. Above that ratio, the tax should be at progressive rates increasing with the increase in the ratio of undistributed earnings to invested capital. For example, undistributed earnings up to 10 per cent of invested capital might be taxed 10 per cent (the rate of the present corporation income tax) with progressive rates above that ratio.

b. While in general, as has been stated, the amount of earnings that should wisely be held undistributed may be said to depend mainly upon the amount of invested capital, it is true that the application of this rule varies somewhat with the size of the corporation. For a large corporation having \$100,000,000 invested capital and earnings of \$20,000,000, \$10,000,000 (10 per cent of capital) might be an ample addition to surplus. A small corporation of \$20,000 invested capital, earning \$10,000, might quite properly want to add \$5,000 to surplus, which would be 25 per cent of its invested capital. It is reasonable therefore to make some concession to the smaller corporations, which could be done by making the rates of the tax on undistributed income progressive also with respect to the amount of the invested capital.

The following scheme of rates is therefore suggested, based on the assumption that corporations pay no income or excess profits tax, and that the present personal income tax remains as it is except that dividends are included in taxable income. While their main purpose is to illustrate the principle, these particular figures have been chosen with the idea of corresponding as closely as possible with the purposes stated.

7. As already indicated, a certain small part of the undistributed earnings of every corporation should be taxed at the lowest normal rate of the personal income tax. This lowest rate should be imposed where necessary to avoid unjust taxation of the small close or family corporation as compared with the small business conducted as an individual enterprise or partnership. In a

Invested capital	Ratio of undistributed earnings to invested capital (per cent)				
	Over — Not over 10	10 30	30 50	50 75	75 —
Not in excess of \$100,000	10	15	20	25	30
Over \$100,000 and not over \$1,000,000.....	10	20	30	40	50
Over \$1,000,000 and not over \$10,000,000.....	10	25	40	50	50
Over \$10,000,000.....	10	30	50	50	50

small individual business with net earnings not in excess of \$5,000, the owner pays personal income tax at the lowest normal rate (4 per cent) and pays no surtax. If such a business were incorporated, it ought not to be taxed at a higher rate (such as 10 per cent). This difficulty can be met by allowing the first \$5,000 of undistributed income of any corporation to be taxed at the lowest normal rate (4 per cent at present).

The result would be equality between the individual and the close corporation so long as net earnings were not greater than \$5,000, and no matter what part of earnings were distributed. For example, assume *A* has an unincorporated business, while *B* has a similar business incorporated, each business yielding net earnings of \$5,000. Assume each is entitled to the \$2,000 personal exemption, taken out of the business earnings. If they have other income, that does not concern us here. Suppose in each case \$3,000 is distributed, \$2,000 undistributed. The result in the two cases would be as follows:

	Income taxable personally	Undis- tributed earnings tax- able to cor- poration	Personal income tax	Corpora- tion tax	Total tax
<i>A</i> (individual)	\$5,000	\$0	\$120	\$0	\$120
<i>B</i> (corporation)	3,000	2,000	40	80	120

Obviously it makes no difference what part of the earnings is undistributed. The individual is taxable on all earnings, regardless of distribution. The corporation's earnings are all taxed either to the corporation or the owner. The only exception is the case where the corporation distributes less than the owner's personal exemption, the owner having no other taxable income. In this case he loses, because he is deprived of part of his personal exemption. As already stated, this case is too rare to be of importance.

We thus take care of the small corporation whose stock is owned (practically) by one person. The same provision would equalize between the small corporation and the partnership, so long as each partner's net earnings were not over \$5,000 (the point at which the surtax begins) and the undistributed earnings of the corporation were not over \$5,000 (the amount taxable at the low rate). For example, suppose *A* and *B* share equally in a partnership; *C* and *D* own each half the stock of a corporation. Each business has net earnings of \$10,000 of which \$5,000 is undistributed. *A* and *B* are each taxed upon \$5,000 income, the tax being \$120. *C* and *D* are taxed each upon \$2,500 of dividends, the tax being \$20. Their corporation is taxed 4 per cent on \$5,000 undistributed earnings, *i.e.*, \$200, adding \$100 each to the tax liability of *C* and *D*. The result is exact equality, and it obviously makes no difference what part of the corporation's earnings (up to \$5,000) is undistributed. There is the same unimportant exception as in the case of the corporation owned by one individual; *i.e.*, when the dividend to each stockholder is less than his personal exemption, and he has no other taxable income.

Thus far we have considered cases where the net earnings of the individual or partner were not over \$5,000. If net earnings are in excess of \$5,000, there may be an advantage to the small incorporated business which does not hold more than \$5,000 of its earnings undistributed. The individual or partner, whose earnings exceed \$5,000, begins to pay surtax, and above \$6,000 his normal rate is 8 per cent, even though part of his earnings are undistributed. The owner of the corporation can have his taxable personal income (dividends) reduced by the undistributed earnings of the corporation and so fall into a lower bracket for the income tax.

This discrepancy in favor of the incorporated business is not serious. It is a maximum where exactly \$5,000 is undistributed. If less is undistributed the difference between the corporation and the individual or partnership becomes continually less, till equality is reached where all earnings are distributed. If more than \$5,000 is undistributed, the higher tax rates would apply to the corporation. Furthermore, all of this discussion applies only to the smaller corporations. The large corporations have many stockholders; to take account of their individual circumstances is impracticable, and the small matter of \$5,000 taxed at a low rate becomes immaterial.

By permitting an amount of undistributed earnings up to \$5,000 to be taxed at the lowest rate, substantial justice is secured between the small close or family corporation and the corresponding individual enterprise or partnership. Discrimination still remains between the small investor in the stock of a large corporation and the small individual business man or partner. Corporate undistributed earnings will generally be taxed 10 per cent or more (the small sum of \$5,000 taxable at the lower rate is insignificant when divided among the shareholders of a large corporation), while the small individual business man or partner gets a lower rate. This is not regarded as a serious evil. It simply means that, so far as undistributed earnings are concerned, "unearned incomes" are in certain cases taxed more heavily than "earned incomes," a principle which is generally regarded as sound.

The wealthy man, on the other hand, has the opportunity to reduce his tax burden on undistributed earnings by corporate investment, as compared with what he would pay upon such earnings in an individual business or partnership. This is because the rates proposed for the tax upon undistributed corporation earnings do not go so high as the personal income tax rates in the present law. The rates proposed are, as stated, a compromise; they could not be made much higher without serious injustice to the many small investors in large corporations. Such discriminations are unavoidable, so long as corporations are taxed as such, without regard to the circumstances of their individual shareholders. It is believed that the rates proposed are on the whole reasonably just to all classes of stockholders.

Furthermore, the favor thus shown the wealthy man is more apparent than real. The reason he gains more than the poor man from incorporating his business lies in the very high rates of the personal income tax upon large incomes. The plan proposed offers no opportunity to the rich man to pay taxes at a lower rate than the poor man. It simply shows him a way to come down a little from his own high rates and approach nearer to the poor man's rate. The rich man is still taxed at a much higher rate than the poor man. And since incorporation is always open to the large business man, it is not likely that any great injustice is done those who voluntarily decline to incorporate. Indeed too much reliance should not be put on the very high rates of the income tax on the largest incomes. It is well known that (through

investment in tax-free securities and otherwise) these highest rates are very commonly evaded. There is no possible way of making a tax upon corporations affect all stockholders the same as though all earnings were personal. The plan here proposed actually goes much farther in the direction of individual justice than the present system of personal income and corporation taxes.

There is every reason for a reduction in the present high surtaxes on individual incomes. If this should be accomplished, either directly by a lowering of rates or indirectly by a special rate on savings as suggested by Professor T. S. Adams,<sup>2</sup> the result would tend to remove the inequality between corporate and unincorporated business in the plan here proposed.

Instead of granting a low rate on the first \$5,000 of corporate undistributed income, justice could be rendered the owners of small close corporations in another way. The law might permit any corporation to elect to be treated like a partnership. This requires simply the calculation of each stockholder's distributive share of the corporation's net income, which share (whether distributed or not) is then taxed to the stockholder as personal income. The corporation would be untaxed. This option, when accepted, would produce absolute equality between such stockholders and individuals and partners. This arrangement would be quite simple and would effectively prevent any injustice to the small or closely held incorporated business. It has some advantages over the plan first suggested.

The foregoing suggestions may be summarized as follows:

1. Retain the present individual income tax, with such revision of rates and other details as may be advisable.

2. Give up the income tax upon corporations, and include all dividends in personal income, subject to the individual income tax. Require of corporations all necessary information as to dividends paid.

3. Interest on bonds and notes should be treated, so far as possible, as personal income, subject to individual income tax.

4. Give up the excess profits tax.

5. Introduce a tax upon the undistributed income of corporations; the first \$5,000 of undistributed income of each corporation taxed at the normal or lowest rate of the personal income tax (4 per cent as at present); above that, undistributed income

<sup>2</sup> See the series of articles by Professor T. S. Adams in the *New York Evening Post*, July 19-August 18, 1920.

taxed at progressive rates with respect to (a) the amount of the corporation's invested capital and (b) the ratio of undistributed earnings to invested capital.

I believe that this plan offers a fair substitute for the present corporation income and excess profits taxes and that it would accomplish the purpose of reasonable revenue to the government and justice to the various classes of taxpayers, without interfering more than is necessary with the wisest management of business by the directors of corporations.

The only serious weaknesses of this plan are those which arise from the necessity of determining the "invested capital" of corporations. Objection will be made to this feature both on practical and on theoretical grounds. From the practical side of administration it will be said that this requirement is one of the most undesirable features of the present excess profits tax. Many have expressed the hope that it might disappear with the repeal of the excess profits tax. That the legal determination of invested capital is complicated and annoying cannot be denied. That it should now be given up is not so certain. The worst stage has been passed. Putting the new device into operation, in the midst of the disturbances incident to war, was a tremendous task. Continuing its operation in time of peace is a matter of less and steadily diminishing difficulty. It is at least open to question whether the progress already made should now be given up. If the most equitable taxation of corporations should seem to require the determination of invested capital, it is reasonable to suggest that the advantage gained may fully compensate for the admitted objections on the administrative side.

There is also a serious theoretical difficulty. If by "invested capital" is understood the value of invested capital, then the whole procedure involves a logical fallacy. The value of any investment depends upon its earnings—its expected future earnings. (Past earnings are of importance only as an indication of what is to be expected in the future.) Logically, we can tax earnings, or we can tax capital; in the first case, we measure earnings objectively without reference to the value of the capital; in the case of capital we must likewise have some objective indication of value, such as records of sales. But if it is proposed to make a tax on earnings depend on the value of invested capital, which itself depends on the amount of the earnings (which are to be substantially reduced by the very tax itself), we are involved in circular reason-

ing. Such a procedure, to be logical, requires that there be some measure of the value of invested capital independent of the earnings. But there is no such independent measure.

The way to avoid this dilemma is to abandon the whole idea of using the *value* of invested capital, and adopt frankly the basis of *cost* of investment. The basis should be what the investors have put in the business and retained there. This will be found, I believe, to agree with the best accounting theory and practice. By this method we avoid the whole matter of price changes, which makes an almost hopeless tangle of the value basis. We take account only of what the investors have actually put in and taken out at the prices actually prevailing in each instance. We do not have to find the value of past investment at present-day prices. This may be somewhat arbitrary and may appear to disregard exact justice between corporations, but any such shortcoming is overwhelmingly offset by the gain in administrative certainty and theoretical correctness.<sup>3</sup> In the main this agrees with the method of determining invested capital in the present law, though the question might be raised whether it is better to take some arbitrary date for the starting point in case of established businesses, as is now done in determining depreciation, or to go back over the whole history of the corporation's investment, as at present in determining invested capital. This question should be answered on the basis of administrative simplicity.

It is imperative that the federal tax system be reorganized without delay. In this reorganization the first step should be to put the taxation of individual incomes and corporate profits upon a logical and equitable basis. After this must come the discovery of such other sources of revenue as may be necessary to balance the budget. The foregoing suggestions are offered in the hope that they may help in some degree to light the path for this first step.

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<sup>3</sup> I think this interpretation of invested capital meets the point raised by Professor Plehn in the *AMERICAN ECONOMIC REVIEW* of June, 1920, page 292.